SCOTIABANK

Q4 2018 EARNINGS CONFERENCE CALL

NOVEMBER 27, 2018

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PRESENTATION

Philip Smith - The Bank of Nova Scotia - SVP of Investor Relations

Good morning, and welcome to Scotiabank's 2018 Year-end and Fourth Quarter Results Presentation. My name is Phil Smith, Senior Vice President of Investor Relations. Presenting to you this morning is Brian Porter, Scotiabank's President and Chief Executive Officer; Raj Viswanathan, our Chief Financial Officer; and Daniel Moore, our Chief Risk Officer. Following our comments, we'll be glad to take your questions. Also present to take questions today are Scotiabank's business line group heads: James O'Sullivan from Canadian Banking; Nacho Deschamps from International Banking; and Dieter Jentsch from Global Banking and Markets.

Before we start and on behalf of those speaking today, I will refer you to Slide 2 of our presentation, which contains Scotiabank's caution regarding forward-looking statements.

With that, I will now turn the call over to Brian Porter.

Brian Johnston Porter - The Bank of Nova Scotia - President & CEO

Thank you, Phil, and good morning, everyone. I'll be starting on Slide 4. The bank reported strong results in 2018. Our team worked very hard to deliver our results.

At the same time, we made significant investments to position the bank for future growth. We completed major acquisitions, made important investments in technology and continued to invest in our people and attract high-quality talent to the bank. I would like to take this opportunity to thank all our employees for their efforts over the past year.

Our recently completed and announced acquisitions will provide value for our shareholders. On a cumulative basis, we estimate these acquisitions will add roughly $2.3 billion in annualized revenues to the bank, contributing growth of 8% to our existing revenue base.

We are proud the bank was able to meet or exceed all of our medium-term objectives in 2018. Adjusted EPS was $7.11 per share, up 9% from 2017. Return on equity was 14.9%, up 20 basis points from last year. We generated positive operating leverage of 3.7%, and our common equity Tier 1 ratio was strong at 11.1%, and our capital rebuild is ahead of plan.

In particular, this was a strong year for our core personal and commercial banking businesses. Canadian banking generated 8% earnings growth year-over-year and closed 2 high-quality wealth acquisitions: MD Financial Management and Jarislowsky-Fraser. Canadian Banking achieved good asset growth, increased margins and delivered positive operating leverage during a period of slowing mortgage growth.

Our focus on core deposits has paid off, with deposit growth exceeding loan growth. We also added approximately 160,000 net new primary customers, excluding acquisitions. Good progress against the Canadian bank's multi-year target of 1 million new primary customers.

Tangerine also performed strongly during the year. Tangerine contributed 1/3 of our net new primary customers to Canadian Banking and continues to be highly popular with millennial customers. Targeted campaigns for deposit gathering also helped Tangerine outpace market deposit growth.

International Banking delivered very strong earnings growth of 16%, with particularly strong results in our Pacific Alliance countries. Our results this quarter also include the acquisition of BBVA Chile and Citibank Colombia. While there was some volatility in the region related to trade negotiations and elections, we delivered record earnings, and our experienced management team is well qualified to manage our businesses effectively.

Global Banking and Markets was down 3% this year, reflecting some challenging market conditions, particularly in the second half of the year. We have strong performances in our corporate and investment banking businesses and more modest results in our capital markets businesses.

Across the bank, total expense growth was well controlled at 2%. Our technology spend in 2018 was $3.3 billion, which allows us to provide a better customer experience while improving productivity and risk management. It is important to note that technology expenses have grown much faster than non-technology expenses over the past 4 years, at an average of 12% versus 3%, respectively.

The benefits of higher revenue growth and our technology investments are reflected in the bank's overall productivity ratio, which has improved 190 basis points year-over-year to 51.7%. And we are on track to achieve our target of 50% or better by 2021.

We see the stable credit performance of the bank in 2018 as reflective of our strong risk management culture and our high-quality portfolios.

Turning to capital. We ended the year with a common equity Tier 1 capital ratio of 11.1%, which includes the impact of acquisitions that closed in fiscal 2018.

This morning, we also announced a divestiture of some non-core operations in 9 smaller countries in the Caribbean and of our life insurance operations in Jamaica, and Trinidad and Tobago. The impact on earnings is not material and the expected capital benefit of these divestitures is approximately 10 basis points.

Exiting these non-core operations is consistent with the strategy that began 5 years ago to sharpen our focus, increase scale in core geographies and businesses, improve earnings quality and reduce risk to the bank. Over this period, we have either exited or announced our intention to exit over 20 countries or businesses, while still meeting or exceeding our medium-term financial objectives. That said, we expect to remain in our core markets across the Caribbean region.

In 2018, we raised our quarterly dividend by $0.06, reflecting an 8% increase during the year. The bank also had some key achievements during the year, which included being named 2018 Bank of the Year by LatinFinance; one of the world's great places to work in 2018 by Fortune magazine; we were added to the Dow Jones Sustainability Index in North America; we were also noted as one of the top 5 most desirable brands for technology workers in Toronto by Hired; and we were added to the Thomson Reuters' Diversity and Inclusion Index.

Turning to Slide 5. We have closed on 4 acquisitions, and our integration efforts are on track. We expect to close our acquisition in the Dominican Republic in Q1/19. From an accretion standpoint, we remain committed to our prior guidance of adjusted earnings per share of $0.15 or more in fiscal 2020.

Turning to Slide 6. We are pleased with our progress against our digital targets. We continue to see improvement across our 3 primary digital metrics since we launched our strategy over 2 years ago. Digital retail sales improved 11%, and we are tracking on or ahead of a plan of 80% of our priority products, which is driving growth in our overall sales. Digital adoption increased by 7%, which continues to accelerate with good growth in all regions. And lastly, in-branch financial transactions have declined by 6%. Focusing on Canada, financial transactions completed by mobile devices have grown 75% over the past 2 years and is now the most popular financial transaction channel for our customers.

I will now turn the call over to Raj to discuss our financial performance, but will return after Daniel for remarks on risk to discuss our outlook for 2019.

Rajagopal Viswanathan - The Bank of Nova Scotia - Executive VP & CFO

Thanks, Brian. I'll begin on Slide 8, which shows our key financial performance metrics for fiscal 2018. All of my comments will be on an adjusted basis, which excludes acquisition-related costs.

The bank ended the year with diluted earnings per share of $7.11, up 9% in 2018. Our P&C businesses that comprise approximately 80% of the bank's earnings delivered a strong performance for the year up 11% collectively. Canadian Banking was up 8% in 2018, reflecting strong growth in assets, continued momentum in deposit gathering, margin expansion, prudent cost management and lower provisions for credit losses.

Lower gains on sale of real estate and the impact from last year's gain on the sale of HollisWealth were partially offset by the current year acquisitions and the alignment of reporting period impacted net income growth by 4%. International Banking delivered strong results, up 16% compared to last year. The results were driven mainly by the Pacific Alliance countries, where we experienced high net interest income growth and fees from good loan growth. The impact of recent acquisitions and the benefit of one additional month of earnings from the alignment of the reporting period in Chile and Thailand contributed 3% to the adjusted earnings growth.

Global Banking and Markets declined 3% from last year, driven by lower capital markets revenue in the fixed income and commodities businesses as well as higher non-interest expenses. These were partly offset by lower provisions for credit losses and higher lending and deposit revenues.

We are actively focused on up-tiering our corporate lending relationships, strengthening our investment banking franchise and growing our customer base in Latin America.

Operating leverage was solid for 2018 at positive 3.7% or 2.4% if we exclude the first quarter 2018 benefits from remeasurement gains. This reflects a very strong performance in our P&C businesses, with positive 1.9% operating leverage in Canadian Banking and a positive 3.1% operating leverage in International Banking.

The productivity ratio improved 190 basis points to 51.7%. Excluding the Q1/18 benefits remeasurement gain, the productivity ratio declined 120 basis points to 52.4%. As Brian mentioned earlier, we remain focused on driving further productivity improvements across the bank.

Turning to the Q4 results. The bank reported diluted earnings per share of $1.77, up 7% year-over-year. Our core personal and commercial banking businesses reported very strong earnings growth. Revenues increased 9% from last year, driven by solid growth in both net interest and non-interest income.

Net interest income was up 10% from strong commercial and retail lending growth in International Banking, which included the impact of acquisitions and strong retail and business loan growth in Canadian Banking. The core banking margin was up 3 basis points versus last year, as the change in business mix from the impact of International Banking acquisitions and higher margins in Canadian Banking was partly offset by lower margin in Global Banking and Markets and asset/liability management activities.

Non-interest income grew 8% compared to last year. The impact of our acquisitions, net of the gain on sale of HollisWealth's last year was approximately 2% of this growth. The remaining 6% growth was due mainly to higher banking and credit card fees, trading revenues and income from associated corporations. Partly offsetting were lower gains on the sale of real estate and investment securities as well as the negative impact of foreign currency translation.

Expenses were up 9% year-over-year or 3% excluding acquisitions. The 3% increase was due primarily to increased investments in technology and regulatory initiatives, business growth-related expenses and the negative impact of foreign currency translation. Partly offsetting were the impact of further savings from cost-reduction initiatives.

The bank improved its productivity ratio to 53.2%, down 40 basis points year-over-year on an adjusted basis. The credit quality of our portfolios remain solid, with a PCL ratio on impaired loans of 42 basis points in line with last year. There were net reversals of provisions on performing loans of about $48 million and when combined with provisions on impaired loans resulted in an adjusted total PCL ratio of 39 basis points.

On Slide 10, we provide an evolution of our common equity Tier 1 capital ratio over the last quarter. The bank reported a CET1 ratio of 11.1%, down approximately 30 basis points from last quarter. The decrease was driven by the completion of acquisitions, which reduced the CET1 ratio by approximately 65 basis points. Partly offsetting this decrease was strong internal capital generation and lower risk-weighted assets. This quarter, risk-weighted assets declined by approximately $11 billion or 3%, due primarily to reduced positioning in the trading book and other market risk changes that were elevated last quarter. Foreign exchange translation impacts, fewer defaulted loans and other favorable increases in credit quality partly offset by organic asset growth.

During the quarter, we repurchased 5 million common shares for a total of 8.3 million shares in 2018. The CET1 impact of transactions closing in 2019 is expected to be offset by selective non-core divestitures and strong internal capital generation. As a result, the common equity Tier 1 ratio is expected to remain above 11% through 2019.

Turning now to the business line results beginning on Slide 11. Canadian Banking reported net income of $1.1 billion, up 4% year-over-year or 7% adjusting for the impact of acquisition-related costs. The results reflect solid asset and deposit growth, margin expansion, improved credit performance and positive operating leverage.

Revenues were up 5% from last year, driven by net interest income growth of 6%. The net interest margin was up 4 basis points year-over-year, primarily due to the impact of Bank of Canada rate increases. Sequentially, margins were down 1 basis point, reflecting lower spreads on residential mortgages and deposits, partly offset by higher credit card spreads. Non-interest income was up 5% due to increases in credit card revenues and credit fees, partly offset by lower real estate gains. Non-interest income from acquisitions was offset by the gain on sale of HollisWealth last year.

Loans and acceptances increased 5% from last year. Residential mortgages grew 3%, credit card 7%, and business loan growth remained strong at 13%. Deposit growth was strong this quarter at 6% year-over-year, surpassing loan growth. Full year residential mortgage growth of 5% was in line with the mid-single-digit growth that we previously indicated.

The provision for credit losses on impaired loans improved 5 basis points year-over-year, but increased marginally by 1 basis point quarter-over-quarter.

On an adjusted basis, expenses increased 5% year-over-year due to continued investments in technology and regulatory initiatives. The division's adjusted productivity ratio of 49.5% improved 20 basis points year-over-year. Full year adjusted operating leverage was strong at 1.9%.

Turning to the next slide on International Banking. Earnings of $712 million in Q4/18 were up 18% year-over-year on a reported basis and adjusted earnings of $746 million were up 22% year-over-year. 7% of the adjusted earnings growth related to the incremental impact of the business combinations and the alignment of reporting period with the bank.

My comments which follow are on an adjusted and constant currency basis. Q4 results reflected strong asset and deposit growth in the Pacific Alliance, positive operating leverage and good credit quality bolstered by the benefit of the recent acquisitions. The Pacific Alliance had very strong net income growth of 17%. Revenues grew 22% or 10% adjusting for the benefit of recently closed acquisitions. The Pacific Alliance saw an increase of 28% in revenue year-over-year or 10% adjusting for the benefits of acquisitions.

Loans grew by 29% compared to a year ago or 10% excluding M&A. Loans in the Pacific Alliance region increased 42% year-over-year or a strong 13% excluding acquisitions in both retail and commercial.

Net interest margin of 4.52% was down 15 basis points year-over-year, primarily due to the business mix impact of the BBVA acquisition as we indicated last quarter.

The provision for credit loss ratio on impaired loans was up 6 basis points year-over-year. Adjusting for the credit mark benefits last year, the PCL ratio improved 14 basis points. Expenses were up 19% or 7% adjusting for the impact of M&A. The 7% increase was driven by the impact of strong business volume growth, inflation and higher technology costs. Operating leverage was a strong positive 3.1% for the full year, leading to an improvement in the productivity ratio of approximately 150 basis points.

Moving to Slide 13, Global Banking and Markets. Net income of $416 million was up 6% year-over-year. The benefit of credit recoveries, lower non-interest expenses and the favorable impact of foreign currency translation were partly offset by lower net interest income. Revenues were down marginally 1% year-over-year, mainly reflecting lower net interest income. Net interest income was down 4% year-over-year, primarily due to lower loan fees as well as lower deposit and lending margins.

Non-interest income was in line with last year. Stronger trading revenues were offset by lower underwriting and advisory fees. The PCL ratio improved 13 basis points year-over-year. The improvement was driven by impaired loan provision reversals in Europe, partly offset by new provisions in the United States. Expenses were down 3% year-over-year, driven by lower performance-related compensation, partly offset by higher regulatory and technology investments. The year-over-year pace of growth on regulatory and technology costs have moderated in line with our expectations.

I'll now turn to the Other segment on Slide 14, which incorporates the results of Group Treasury, smaller operating units and certain corporate adjustments. The results also include the net impact of asset/liability management activities.

The Other segment reported a net loss of $64 million this quarter. The net loss in this segment increased year-over-year due to significantly lower net gains on the sale of investment securities and lower net interest income from asset/liability management activities, partly offset by lower non-interest expenses.

This completes my review of our financial results. I'll now turn it over to Daniel, who will discuss risk management.

Daniel Moore - The Bank of Nova Scotia - Executive VP & CRO

Thank you, Raj, and we'll turn now to Slide 16. We are comfortable with the fundamentals of the bank's risk portfolio. Our PCL ratio on impaired loans, or what is referred to as stage 3, was stable at 42 basis points compared to last quarter and the comparable period a year ago. On a total loan book basis and excluding the Day 1 impact on acquired performing loans in third quarter 2018, the all-bank PCL ratio was also stable versus last quarter.

The results included a $47 million net reversal on performing loans, primarily in the International Banking, driven by the reversal of the hurricane-related provision, which is no longer required in the commercial portfolio, asset sales and credit quality improvements in the retail portfolio.

Overall, we're seeing stable loan loss ratios in our Canadian personal and commercial banking business relative to last quarter, as higher impaired credit losses were driven mainly by higher commercial provisions.

Moving on to International Banking. We continue to see good credit quality trends and the benefits of our diversification. Higher retail impaired losses were primarily due to higher provisions, driven by the full quarter impact of acquisitions, while lower commercial provisions were due to higher recoveries.

In Global Banking and Markets, recoveries were driven mainly by impaired provision reversals in Europe, partly offset by new provisions in the U.S.

This quarter, we also took additional provisions relating to the debt restructuring in Barbados, which is not material to the bank, and we expect our operations there to return to full profitability this year.

Now looking at other credit metrics. Gross impaired loans declined to $5.1 billion from $5.3 billion last quarter and the gross impaired loans ratio declined versus last quarter, while net formations of $713 million were near the 2-year average.

Turning now to Slide 17. You can see the recent trend in loss ratios for each of our businesses. Canadian Banking's impaired credit loss ratio increased 1 basis point versus last quarter. International Banking's impaired PCL ratio declined 13 basis points over the last quarter from 133 basis points to 120 basis points, driven by improvements in the commercial portfolio, due to recoveries in Puerto Rico and in Latin America. As a result, International Banking's total PCL ratio declined by 18 basis points compared to the adjusted total PCL ratio of 123 basis points last quarter.

Overall, our credit portfolios continue to reflect the benefits of broad diversification, and we believe that our underlying performance remains strong.

Turning to Slide 18. You can see the recent trend in net write-off ratios for each of our businesses. Looking over the last 5 quarters, our net write-off ratio has been relatively stable. We would expect that trend to continue.

In Canadian Banking, we have seen the ratio decline 6 basis points year-over-year, primarily due to improvements in our retail portfolio due to our continued focus on up-tiering customers in our unsecured lending portfolio and due to enhanced collection strategies.

At current levels, our allowances provide us coverage of approximately 8 quarters worth of net write-offs. We are well prepared for a variety of future economic scenarios. And we will continue to manage risk in a prudent and in a responsible manner.

Turning to Slide 19. We are here providing a view of our exposures in the energy sector, given the recent decline in oil prices and widening differentials in Canada. As you can see, approximately 1/5 of our energy lending is to Canadian exploration and production producers. We have conducted a thorough analysis of our portfolio and have determined that approximately 8% of our portfolio has some exposure to Western Canada Select or WCS. Of that $1.2 billion, almost $1.1 billion or nearly 90% is of publicly traded, investment-grade corporate customers who have diversified revenue sources with only a portion of their revenue coming from WCS.

Finally, as we look back to our experience with lower energy prices in 2015 to 2017, we draw strong comfort from the high-quality nature of our portfolio and the related loss experience which was better than expected. Today, our portfolio remains high quality and our underwriting standards have not changed.

Turning now to retail. Alberta represents 14% of our retail portfolio. Over 90% of which is secured. Delinquencies are stable, with improvements in 91-plus day delinquency year-over-year, including 100 basis points improvement in credit cards and 50 basis points improvement in our unsecured lines, as we continue to be vigilant in managing credit quality with this portfolio.

I'll now turn the call back over to Brian for some closing remarks.

Brian Johnston Porter - The Bank of Nova Scotia - President & CEO

Thank you, Daniel. Before we open up the call for questions, I'd like to provide some thoughts on our outlook for 2019. We are optimistic that we will continue to perform strongly and, again, exceed our medium-term objectives. The economic outlook in our key markets is positive. The integration of our acquisitions is proceeding well. Our capital position is strong. And the impact of our digital efforts is accelerating.

We are in a rising interest rate environment, which is positive for margins. An important area of focus for us in the year ahead will be to successfully integrate our recent acquisitions. In fact, we think about integration as a key theme for the bank in 2019. This will be critical to unlocking the full revenue and earnings potential of the acquisitions.

On the macro front, while we're mindful of emerging risks, we're encouraged by the positive economic conditions in the Americas, including most of our Pacific Alliance countries, a region of 230 million people where we are a leading bank.

I will now provide some specific comments on the outlook for each of our business lines.

Canadian Banking is focused on optimizing its business mix, driving higher productivity and acquiring new primary customers. James and his team will be driving improved productivity towards our 49% target or 45% for Canadian Banking ex wealth, supported by higher revenue growth and mid-single-digit expense growth in 2019; integrating our recent acquisitions in wealth while maintaining strong retention rates with our customers and advisers; identifying opportunities to prudently advance our higher-margin businesses by leveraging data analytics to increase credit card and small business banking; also increasing core deposits which is an anchor product in our definition of primary customers.

We expect margins to be higher in 2019, supported by higher interest rates. The exact timing of rate increases will be a key determinant for the magnitude of any margin increase. Residential mortgages are also expected to grow at mid-single-digits in 2019. And we see higher organic growth in credit cards in business volumes, which are expected to remain robust in 2019. Overall, we expect Canadian Banking to generate growth in line with our medium-term target of 7% plus in 2019.

For International Banking, the outlook continues to remain positive. In 2019, International Banking will be singularly focused on integrating our recent acquisitions in Chile, Peru, Colombia and the Dominican Republic. Our pipeline of business in corporate and commercial banking is higher than levels we saw last year this time. Expense management will continue to be a key priority and productivity improvements remain a focus. Our new core banking system in Mexico will help drive further productivity improvement.

Overall, we remain confident in the medium-term growth outlook for International Banking, which calls for constant currency earnings growth of 9%.

Turning to Global Banking and Markets, we expect our businesses to grow in 2019. We have seen some weaker results due to challenging market conditions as well as some repositioning of our businesses. Looking ahead, we expect improved results given we have completed the repositioning of our Asia trade finance businesses and our Mocatta business. We are building out our investment in corporate banking presence here in Canada and internationally. And we expect improved market conditions for our capital markets and trading businesses.

In summary, the bank remains confident in our ability to achieve our medium-term financial objectives. In 2019, we also look forward to hosting our first Investor Day in Chile to provide our external stakeholders a better understanding of our business and the country. Importantly, we will have the opportunity to provide a more detailed update of our integration progress with BBVA Chile and demonstrate our capabilities in the region. The Investor Relations team will be sending out a "Save The Date" in due course later in December.

And with that, I'll turn the call back to Raj for the Q&A.

Rajagopal Viswanathan - The Bank of Nova Scotia - Executive VP & CFO

Thanks, Brian. That concludes our prepared remarks. We'll now be pleased to take your questions. Operator, can we have the first question on the phone, please?

QUESTIONS AND ANSWERS

Operator

We will now take our first question from Robert Sedran of CIBC Capital Markets.

Robert Sedran - CIBC Capital Markets, Research Division - MD & Head of Research

James, it's on the mortgage front, I know Brian mentioned sort of mid-single-digit the idea for 2019 and hasn't been doing that, at least not this quarter and perhaps there is some seasonal weakness in there. Can you talk a little bit about a) what's going to bring that mortgage growth back and b) and I think, more importantly, at this point, a little bit about the competitive environment and the margin you're getting on the marginal mortgage that you're adding considering how a few of them there are around right now?

James O'Sullivan - The Bank of Nova Scotia - Group Head of Canadian Banking

Sure. Happy to, Rob. So residential mortgage growth continues, I would say, more or less as expected. So we had 3% growth in average balances year-over-year and 5% for the full year. So I think we've delivered on our outlook and our plans in this regard overall. For 2019, I think mid-single-digit growth is also our outlook. So it's that kind of 4% to 6%, Rob, I'd be thinking about the lower end of that range as we see the world today. So I think there is some room here for mortgage growth to decelerate from 2018 levels overall. And I'd remind you, we've discussed this on previous call that a 1% reduction in mortgage growth has about $10 million to $15 million impact on net interest income, depending on the spread. So it's something that can be replaced certainly. On the competitive environment, look, I would readily say that we're seeing a very competitive mortgage market. B20 and higher rates, both necessary and we think both long-term positive have been disruptive in the short run. My view is that participants in the mortgage industry spent probably much of 2018 defending the market share that they had before B20 and rising rates. So we'll see how 2019 unfolds. We've always said that our appetite will be governed by our assessment of risk, our assessment of reward. And, look, we continue to see modest risk here, but recently, we've seen declining reward also. So to sum up on mortgages, we like our position, we've talked in the past about our 3-channel strategy, you should expect us, I would say, to be a top 3 participant in this industry overall.

Robert Sedran - CIBC Capital Markets, Research Division - MD & Head of Research

James, do you think that reward you talk about in terms of the margin, the marginal business, is it enough to color the outlook for the net interest margin for the segment as a whole? Or is it a manageable impact and we should still be expecting to see that margin rise in 2019?

James O'Sullivan - The Bank of Nova Scotia - Group Head of Canadian Banking

So if you look at margins kind of sequentially quarter-over-quarter, I describe it as stable. It was down 1 basis point sequentially. But if you peel that back, we gained 1 basis points on credit cards and we lost 1 basis point on each of mortgages and brokered deposits. So the mortgages are the big buck, it's the largest buck by credit magnitude, as you know. So it does have the potential and, in fact, does influence margin each and every quarter. Having said that, Rob, look, for 2019, we believe the direction is, certainly given our interest rate outlook, we're planning for overnight rate increases to the low end of the neutral rate range, so that's 2.5%. So we expect good margin expansion in 2019. In fact, we'd expect more margin expansion in 2019 than we saw in 2018. And I think what's going to offset that very competitive mortgage market is, I think, the pretty impressive momentum that we have in deposits. Deposits are now growing at 6% year-over-year. That's faster than loan growth. And last quarter, we saw this on a spot basis, this quarter you see it in the averages. So look competitive dynamics are going to be a factor for sure. But our momentum in deposits is certainly going to help with margin overall.

Operator

We will now take our next question from Meny Grauman of Cormark Securities.

Meny Grauman - Cormark Securities Inc., Research Division - MD & Head of Institutional Equity Research

I wanted to know how you would describe the change in your strategy in the Caribbean, and specifically, the considerations that you look at as you're deciding since it's the bulk up in the Dominican? And then on the other hand, divest those 9 markets that you revealed earlier this morning?

Brian Johnston Porter - The Bank of Nova Scotia - President & CEO

I'll start, it's Brian, and Meny, thank you for the question, and Nacho may have a comment as well. When you look at what we've retained in the Caribbean, that's 90% of the population. And this strikes at the core of our strategy to bulk up and get scale in markets in geographies and businesses that we deem important where we can turn the dial for our customers and our shareholders. As far as the insurance business goes, we've always said that we didn't want to be in the underwriting business, we want to be in the distribution business. This is a relatively small business. And so that made sense for us to dispose of that. But in terms of the DR, DR is a bit different and it's a country of over 11 million people. In the contrast that to Jamaica, Jamaica is 2.8 million people. So the DR has size, it has scale. It has average GDP growth over the last 10 years of 5.5%. It's a dynamic market. We've operated there for over 9 years. We're very comfortable operating in the DR, and we look forward to growing our business there.

Meny Grauman - Cormark Securities Inc., Research Division - MD & Head of Institutional Equity Research

And just as a follow-up, just trying to understand, is the motivation here in terms of the timing of these announcements, is it really capital as the main motivation?

Brian Johnston Porter - The Bank of Nova Scotia - President & CEO

No, it's core strategy, Meny. So we've been working on this for some time. And as I said in my text, I think the exact number is over the course of last 5 years, we've exited 22 geographies or businesses that we viewed as non-core for the bank and we're re-deploying that capital in our major markets and our major businesses.

Operator

We will now take our next question from Steve Theriault of Eight Capital.

Stephen Gordon Theriault - Eight Capital, Research Division - Principal & Co-Head of Research

I have a question for Nacho, but if I can just follow-up on Rob's question to James for a second. You talked about deposits helping with the margin next year. What about credit cards? Brian mentioned a focus on higher margin products. I've noticed some higher promotional activity on your cash back card. That 7% growth in cards this quarter, is that indicative of what you'd expect next year? Or is there upside to that as you push on the gas a little bit here in terms of cards?

Brian Johnston Porter - The Bank of Nova Scotia - President & CEO

Hopefully, a bit of upside. So again, average balances are up about 8% year-over-year, and 5% for the whole year. Purchase volumes are up actually quite a bit more than that. And we haven't talked very much about Tangerine's credit card, but its balances are up 31% for the whole year. So as we think about next year, we'd be thinking about high-single-digits for credit card growth with a particular ongoing focus on A&B customers and working with Daniel Moore's credit risk analytics team, we have done a better and better job of targeting A&B customers and extending credit limit increases, for example, to the most creditworthy of our current customer base.

Stephen Gordon Theriault - Eight Capital, Research Division - Principal & Co-Head of Research

And I'd expect then we'll hear more in your margin discussion like there is potentially some upside to margin from cards?

Brian Johnston Porter - The Bank of Nova Scotia - President & CEO

Yes, absolutely. So margin will evolve as rates evolve and as business mix evolves, but cards certainly will be accretive to margin as we execute these plans.

Stephen Gordon Theriault - Eight Capital, Research Division - Principal & Co-Head of Research

Okay. And then just quickly for Nacho. Expenses in International, you've got some acquisitions that closed in the back half of this year, some closing in the front half of next year, maybe a bit of an outlook on expenses? Brian touched on it in his comments, but should we still expect positive operating leverage next year? Or does it take a little time to get back on track with the acquisitions and integrations that are ongoing?

Ignacio Deschamps - The Bank of Nova Scotia - Group Head of International Banking & Digital Transformation

Thank you, Steve. Well, we're very pleased with the management of expenses, and this year, we have above 3% operating leverage. And going forward, we are confident we'll continue to deliver positive operating leverage. Overall, we expect better economic conditions in the Pacific Alliance countries, growth around 3%. And that will support our deposit growth, our asset growth, and we're confident on our guidance of 9% earnings growth for the Pacific Alliance countries and IB.

Stephen Gordon Theriault - Eight Capital, Research Division - Principal & Co-Head of Research

And Nacho, I noticed that the GDP growth for Chile for '19 is down almost 4% from what we saw 3 months ago. Are you feeling any less enthusiastic for what you can deliver next year on Chile with adding in BBVA? Maybe just a little color on lower expected GDP growth?

Ignacio Deschamps - The Bank of Nova Scotia - Group Head of International Banking & Digital Transformation

No. I'm feeling very confident about Chile. Let me update you on Chile as the transaction closed in Q3, 60 days after the merger took place. Let me give you just a few examples of the progress. The first 3 levels of the organization have been integrated into one management team that is fully focused in the business and in our customers. We have had no customer attrition. Next year, we expect it to grow 6% of our assets. Now we're thinking we will be able to grow between 8% to 10%. And early this year, Brian and myself were in a very important event with 10,000 customers, the President of Chile, the Minister of Finance. There is a very positive business environment. There was some additional expectation of growth, but growth is going to be strong, above 3% for Chile next year. And we're fully focused on our integration. We expect to capture around $40 million of synergies pre-tax. And overall, we expect also our earnings pickup to be around $70 million during the first year. So really a very positive development and the integration going very well.

Brian Johnston Porter - The Bank of Nova Scotia - President & CEO

Just to add to that, if I may, Steve, is that, when Nacho and I met with the President and the Minister of Finance, this year GDP growth will close out at 4%. Next year, the country's forecast is 3.8%. So still strong GDP growth.

Operator

We will now take our next question from Doug Young of Desjardins Capital Markets.

Doug Young - Desjardins Securities Inc., Research Division - Diversified Financials and Insurance Analyst

Just on the Pacific Alliance countries, and if I do just for the 4 PAC countries and I look at earnings for the quarter, it looks like it was up nicely. But then when I just compare overall to your Latin America earnings on Page 22 of the sup, there seems to be a big delta. And so, I'm just doing back-of-the-envelope calculations here, but was there any noise in the smaller Latin American regions outside of the big 4 that any bumps or noise to think about here? And then along the same lines of what you did in the Caribbean, and is there an opportunity to consolidate or get out of some of these smaller Latin American regions outside of the 4 big countries which operate in similar to what you did in the Caribbean?

Brian Johnston Porter - The Bank of Nova Scotia - President & CEO

The only other smaller country in Latin America that would fit that category is Uruguay, and we've got a great operation. It's very well run there. It's very profitable. And we don't contemplate exiting that business. The noise is probably our wholesale operation in Brazil, which has been very profitable for us and is well run, and that business is really focused on investment-grade public companies where we're providing investment banking, corporate banking services. So we like that business. It's consistently profitable. So in terms of possible divestitures this year where in terms of our non-core plan, as I said, we've exited 22 business or geographies in the last 5 years. We've got a couple more to go, and you'll hear more from us in 2019, but they don't pertain to Latin America or Pacific Alliance.

Ignacio Deschamps - The Bank of Nova Scotia - Group Head of International Banking & Digital Transformation

And if I may add, Brian, our focus is in the Pacific Alliance countries and our growth has been strong at 17% year-over-year. Full earnings growth has been very strong. And this is really a very positive development in terms of assets and deposit growing around 30% and 50%, nice pickup of growth in retail deposits, in commercial 3% – in retail, sorry, 3% Q over Q. So we're confident on our guidance for the Pacific Alliance countries going forward.

Doug Young - Desjardins Securities Inc., Research Division - Diversified Financials and Insurance Analyst

And Nacho, just while I have you, just one quick follow-up. The earnings in the quarter, just from BBVA Chile, I think last quarter just for 1 month, it was $15 million, correct me if I am wrong. What was it for Q4?

Ignacio Deschamps - The Bank of Nova Scotia - Group Head of International Banking & Digital Transformation

$20 million.

Operator

We will now take the next question from Darko Mihelic of RBC Capital Markets.

Darko Mihelic - RBC Capital Markets, LLC, Research Division - Financials Analyst

A few questions here. I wanted to dive into the energy exposure just a little bit. First, I wonder if we can just revisit the concern is obviously WCS. But NatGas is – well, I mean, I guess, the question I have relates to the assumptions that you're using on a go-forward basis. And the last time we had low oil prices, you guys kind of provided a bit of a stressed sort of scenario or sort of an outlook. Is there anything you can provide or give us some sort of ideas as to what assumptions are underlying your Stage 1, Stage 2 allowances?

Daniel Moore - The Bank of Nova Scotia - Executive VP & CRO

Sure, Darko. Thank you for the questions. It's Daniel Moore here. So we do stress portfolios regularly and we draw comfort from the results as well as we don't see a material impact from either the move in WTI or in the Eco-gas in our portfolios. I would stress to you that the most important thing that drives our outlook on ECLs is obviously first the growth of the portfolio, and secondly, the book quality. And we've been very, very focused on book quality for both WCS and for NatGas, you can see from our disclosure here, you can see some 65% reduction rate that we have in the book. And so right now we think we are conservatively and adequately positioned for our book exposure.

Darko Mihelic - RBC Capital Markets, LLC, Research Division - Financials Analyst

I guess, in the past, what I'm getting at is, it was sort of like a view of, if prices were to stay at these levels, there would have been cumulative losses of $450 million to $500 million over a period of couple of years. That would be different now, right? I mean, presumably, there would be no such thing. You would, in fact, take, if you were to assume that prices stayed as well, you would take the hit for Stage 1 and Stage 2 today. And so, effectively what you're kind of – am I to interpret this that if we assume these prices sort of stay, there's still no losses built in the book that should have been recognized? I mean, I'm just trying to reconcile that.

Daniel Moore - The Bank of Nova Scotia - Executive VP & CRO

Yes, Darko, there's the quantitative element of IFRS 9, there's also the capacity there for extra credit adjustment to look at where our models are lagging the exposure that we see internally from management perspective, looks of a conservative and appropriate nature. But when we – yet again, look at our book right now and we focus on upstream E&P and WCS, which is 70% of our overall E&P authorization are exposed to WCS; 90% of that is investment-grade. Those companies have access to markets and many include refining operations that will benefit from the wider crack spreads. So only 1% of our overall E&P exposures are to some investment companies that are exposed to WCS and that's where we historically see losses and that wouldn't be a material position for us today. Perhaps, I can hand it over to Dieter to see what he is seeing.

Dieter Werner Jentsch - The Bank of Nova Scotia - Group Head of Global Banking & Markets

Darko, I've been managing the majority of this portfolio last three years. And I have to say to you, since 2015 and '16, we've up-tiered our companies we deal with and our counter parties. And I have to say to you that our balance sheets that we see in the business has never been as strong, and the management teams are very cost-conscious, and very revenue-efficient and we feel very proud of the names that we bank. And they have a disciplined view of capital deployment, and look, I'm very confident that this will withstand a period of unsettlement in the commodities market.

Darko Mihelic - RBC Capital Markets, LLC, Research Division - Financials Analyst

Okay. That's very helpful. I appreciate that. And then just one last question on it. Daniel, just with respect to WCS, if it stays this low, we know that there is a bit of correlation with unemployment in Alberta with low oil. So – and I noticed that you actually have an overall upbeat view. In other words, Canada's GDP is rising. So I'm curious, with the 14% exposure in Alberta, are you assuming an uptick in unemployment in Alberta, and I guess, that's just not material enough to impact the books?

Daniel Moore - The Bank of Nova Scotia - Executive VP & CRO

Yes. Unemployment will be one driver, and today obviously as you know, we're not seeing an uptick in unemployment there, but we monitor that situation very closely. But the biggest thing I can give you Darko is how 93% of our portfolio in Alberta from a retail perspective is secured. The other key message I'll leave you with is that we've been paying close attention to the portfolio quality since 2016 and we never took our eyes off the road. The de-risking measures that we have in place after recession in Alberta in 2016, the significant investments and selections scoring and credit analytics that we put in place are still in place today. And that's the position of comfort that we have now in the retail portfolio. Our proactive measures are paying dividends as James said, and it will continue to going forward.

Operator

We will now take our next question from Ebrahim Poonawala of Bank of America Merrill Lynch.

Ebrahim Huseini Poonawala - BofA Merrill Lynch, Research Division - Director

One, I guess I just wanted to follow-up first, Raj, with a question on the margin in Canada. So it sounds clear that the higher rate should be beneficial to the margin. What if we don't get a rate hike in the first half of next year? Where does that leave your expectations for the margin in Canadian Banking?

Rajagopal Viswanathan - The Bank of Nova Scotia - Executive VP & CFO

Yes. It's a very difficult one to answer, there are so many new moving pieces here. I have not seen a scenario in front of me where we do not have more margin expansion in 2019 than 2018. I think that all I can say at this point, kind of readily acknowledging that we don't have a crystal ball on the timing of rate increases and clearly competitive dynamics in various lending and deposit markets are going to play be a significant factor here.

Ebrahim Huseini Poonawala - BofA Merrill Lynch, Research Division - Director

And you provided good color on a loan pricing. Having said that, like deposit growth, as you said, has been a robust. Can you talk about the pricing competition on the deposit side? Is it safe to assume that the incremental asset growth is happening at better spreads relative to where the margin was in the fourth quarter?

Rajagopal Viswanathan - The Bank of Nova Scotia - Executive VP & CFO

Well, on the profits, what I would say is, it's quite competitive there too. I think we're seeing money moving both within institutions and between institutions as rates move higher. Within institutions, we're seeing a preference for term deposits, clearly. And between institutions, we are seeing, as I'm sure you are, a lot of rate campaigns out there. But I just want to highlight, we look at this through three lens. We look at it through a customer lens, a funding lens and an economic lens. So let's go through those. Through the customer lenses, we feel very strongly that an investment conversation that includes deposits has got to be a key part of our primary banking strategy. Through the funding lens, we continue to believe that good retail deposits remain a corporate priority. And through the economic lens, look, in a rising rate environment which we're in, a deposit should be an increasing source of value to our shareholders. So we're going into 2019 very much with a plan to have deposit growth continue to exceed loan growth. That's what we seek to achieve.

Ebrahim Huseini Poonawala - BofA Merrill Lynch, Research Division - Director

And I guess, moving to sort of International Banking. One, if you or Nacho wants to add to this, but expectations are on the margin relative to the 4.52% in the fourth quarter, is it still kind of relatively flat? Or should we expect that to trend lower?

Ignacio Deschamps - The Bank of Nova Scotia - Group Head of International Banking & Digital Transformation

No. Our markets are stable like they have been in the last 16 quarters, we're plus/minus 10 bps variation due to our footprint. Now in this quarter, we have incorporated the assets of BBVA Chile. This is a more mature country; it has lower risk, lower margins. So now of our margin is 4.52%, and we expect that to be stable going forward, again with a plus/minus 10 bps variation.

Ebrahim Huseini Poonawala - BofA Merrill Lynch, Research Division - Director

And any thoughts on Mexico, I mean, obviously, we've seen some more political risks pick up over the last few weeks. Anything that would cause you to change in terms of how you approach growth in the near-term? Any thoughts would be helpful.

Ignacio Deschamps - The Bank of Nova Scotia - Group Head of International Banking & Digital Transformation

We have seen over the last few quarters some negative market sentiment around Mexico due to NAFTA due to the political situation. We saw this really a few days before the inauguration. The transition is going to take place in government on December 1. We continue to do very well in Mexico. We have whole year earnings growth above 30%, with strong growth loan and operating leverage of 10%. I would also like to highlight that the President López Obrador has mentioned to us and publicly the importance of the relationship of Canada. Canada was the only country where he sent a mission of seven of his future ministers. We hosted here at Scotiabank in Toronto, The Minister of Economy, a productive conversation with the automotive industry and the pension funds. So there is, of course, some noise that also the President and his Finance Minister have been quick to clarify. They have expressed a solid commitment with macroeconomic fundamentals and disciplined public finances. So we continue to see an attractive medium-term growth profile for Mexico going forward.

Operator

We will take our next question from Gabriel Dechaine of National Bank Finance.

Gabriel Dechaine - National Bank Financial, Inc., Research Division - Analyst

Brian, you touched upon the disposition questions earlier and you said there might be more in the year ahead, outside of LATAM. I'm wondering if there is an update on the Thanachart situation?

Brian Johnston Porter - The Bank of Nova Scotia - President & CEO

I can't get into the specifics, Gabriel as you know, but we started a program, as I said, 5 years ago. We're well through it. And we're focusing on our major markets, geographies and businesses. And it goes back to the theme as there is a pattern here is that we're the #3 bank in Chile, we are the #3 bank in Peru, we'll be the #3 bank in the DR. We've added to our wealth businesses as we said that we would in terms of the institutional business and the high net worth category. So we've been bang on strategy on all these. And this year, it's going to be focused on integration. And our capital rebuild is ahead of plan. We're proud of that. And this bank has the ability to generate a lot of capital internally. And so 2019 is an important year for us to get these acquisitions down, and you'll hear more from us in subsequent quarters.

Gabriel Dechaine - National Bank Financial, Inc., Research Division - Analyst

And then my next one is on the commercial lending growth in Canada. And I don't want to signal you guys, it does seem like we're getting these double-digit growth numbers from pretty much every bank. And you did quite well this quarter. Just wondering how do you still have – or what's your outlook for commercial growth sustaining in the double-digit levels when we have Canadian GDP in the 2% range, what's driving that? I see from your supplement here, Page 16, a big component of the growth has been the real estate and construction portfolio. And again, I see that across the group. So with mortgage growth slowing, starts falling off of peak levels, the economy not looking as strong. How sustainable is that growth? And I know it's not going to be the driver either, I don't think. I'd like to hear your thoughts?

James O'Sullivan - The Bank of Nova Scotia - Group Head of Canadian Banking

Sure, a few thoughts. So first on the real estate development, I think that has pretty consistently represented about 25% of Gillian Riley's business overall. I mean, let me give you a couple of thoughts here then. So what our observation is as we travel the country is that companies are investing. Real interest rates are low. Capacity utilization is quite high. And labor markets are tight. So this is – I think many business owners have concluded that this is a time to be investing in the business. And Gabriel, I did speak to our economists on this question, this good question of how long can business loan growth exceed nominal GDP growth? And their view or their observation would be this, that the business loan growth typically does not run faster than nominal GDP for about more than a decade, say, when they look across OECD countries. And in Canada, we've seen high levels of business loan growth relative to GDP, we saw it in the late '70s, through the early '80s, the late '80s through early '90s. And this time it started kind of in 2012. So you put all of that together and our view is that this period of kind of heightened investment in businesses can and should continue. And that's what we're planning on as we invest across this country geographically and sectorally including agriculture and a number of different areas that we talked about in the past.

Gabriel Dechaine - National Bank Financial, Inc., Research Division - Analyst

The acceleration in mortgage growth really doesn't have any trickle effect into commercial or wholesale lending, or other areas?

James O'Sullivan - The Bank of Nova Scotia - Group Head of Canadian Banking

I would say, look, I think all markets are connected. So I am not going to say they are disconnected. But we are expecting our real estate development business, the financing of that to grow next year. That business is very much focused on kind of Tier 1 developers in Toronto and Tier 1 developers in Vancouver. I wouldn't be surprised if it moderated somewhat. But as I said, it's 25% of the overall commercial business. And we've got a special focus on small business lending as well these days. So overall, Gabriel, we see business lending, if you want to call it that, it's – our plan is for double-digit loan growth next year.

Operator

We will now take our next question from Scott Chan of Canaccord Genuity.

Scott Chan - Canaccord Genuity Limited, Research Division - Director of Research of Financials & Financial Services Analyst

Perhaps I'll switch over to wealth management. And maybe just a big picture with the market volatility we've seen since October. Just in terms of kind of net flows on the institutional retail side, and if there is any incremental commentary related to MD as well?

James O'Sullivan - The Bank of Nova Scotia - Group Head of Canadian Banking

So on wealth, look, I think the wealth business overall is performing well. It is harder to see with the acquisition and the disposition activity over the past year with MD, Jarislowsky-Fraser and HollisWealth. But if we look at what we might call organic wealth, that business is up in earnings 14% year-over-year and 10% for the full year. So I think a solid to a strong year overall on the organic business. Clearly, underneath that, there are different things going on. The wealth management side of the business is particularly strong. So as we've discussed in the past, delivering all of this organization holistically to clients who need advice and solutions is clearly a driver of earnings currently and going forward.

The retail asset management side of the business is, all I'd say dealing with the headwinds that you're very familiar with. And it certainly has more modest levels of growth. But overall, we think we have good product, good performance in that product too, and I think a lot of channels to sell through. So again, if you look at organic wealth in AUM, in particular, that's probably down 3% year-over-year. Organic AUA would be down about 2% year-over-year. So the market fall and lower sales to mutual funds are contributing here, but the business printed a pretty solid year.

On the acquisitions, I'd say we're very pleased to this point. MD Financial closed, I believe, on October 3. I've said in the past, we've said in the past, that job 1 is retention. That's going very, very well. Job number 2 is going to be defining and executing growth plans, and that's very much our intention for each the Jarislowsky-Fraser and MD as we head into 2019.

Operator

We will now take our next question from Sohrab Movahedi of BMO Capital Markets.

Sohrab Movahedi - BMO Capital Markets Equity Research - Analyst

Brian, I just wanted to see where buybacks are relative to the capital deployment plan now? I know you did $4 million or $5 million in the quarter, $8 million in the year. Do you expect that pace to pick up now that you've got the capital on a pro forma basis closer to 11.2%?

Brian Johnston Porter - The Bank of Nova Scotia - President & CEO

Yes, it's always in the toolbox Sohrab and with the stock trading where it is, we view it as extremely attractive and that's certainly an option for us. And we're not in the business of acquiring anything this year as you well know, we're in the business of integrating what we've purchased. And as I said on a prior question, we have a strong ability to generate capital internally here. And so we're very comfortable with our capital levels here and certainly deploying it in share buybacks is an option that we have.

Sohrab Movahedi - BMO Capital Markets Equity Research - Analyst

And the small dispositions that you've noted, they won't have – will they have any earnings implications that we should think about?

Brian Johnston Porter - The Bank of Nova Scotia - President & CEO

It's not material, Sohrab.

Rajagopal Viswanathan - The Bank of Nova Scotia - Executive VP & CFO

Thank you, everyone, for participating in our call today. And we look forward to speaking with you again in February next year. Have a great day.